

**COORDINATED ISSUE
CONSTRUCTION/REAL ESTATE INDUSTRY
USE OF IRC 482 AND/OR SUBPART F FOR SERVICES TO CFCs**

ISSUE AND FACTS

Whether the taxpayer is (a) making a proper charge under IRC 482 for services performed for, or provided to, its controlled foreign corporations (CFC), or (b) reporting subpart F income under IRC 954(e) for these services.

Due to the increase in American business activity in foreign markets, some taxpayers have increased their use of Controlled Foreign Corporations (CFCs) to minimize and/or avoid taxes. Methods have been developed whereby this avoidance or reduction of tax is difficult to detect, difficult to analyze and understand, and difficult to take issue with. These methods could involve:

1. Providing of services to a CFC at no charge, or at a charge which is less than an arm's length charge.
2. Providing of tangible and intangible assets to a CFC at no charge, or at a charge which is less than an arm's length charge.
3. Arbitrary shifting of income and deductions between the parent company and CFC.
4. Providing loans to a CFC at no charge or at a charge which is less than an arm's length charge.

LAW AND ANALYSIS

Through IRC 482 the Commissioner is authorized to allocate or adjust income, deductions, credits and allowances among related taxpayers in order to prevent evasion of taxes or to clearly reflect the income of those taxpayers. The Commissioner's increased effort under IRC 482 in the foreign area was principally initiated in 1960 with the adoption of an accelerated International Enforcement Program to review arrangements between U.S. taxpayers and their related foreign entities. In order to bring IRC 482 to bear, three basic statutory requirements must be satisfied; that is:

1. The taxpayers among whom an allocation or adjustment is asserted must be under common control;

2. An evasion or avoidance of tax, or failure clearly to reflect income, must be present; and
3. The proposed allocation among the members of the commonly controlled group must prevent this evasion or avoidance of tax, or otherwise must accurately reflect the true income of the parties.

IRC 482 issues can arise in a variety of circumstances and each must be resolved on its particular facts. In every case, regardless of the issue involved, it is essential to know:

1. The details of the questioned transactions as they actually happened;
2. The functions which were performed to accomplish the transaction;
3. Which organization performed each function (functional analysis); and
4. The method or basis upon which the intercompany charge was made, or not made, by the taxpayer.

If we use IRC 482, Item #3 is considered to be of prime importance because of the functional analysis. This analysis involves going beyond the books and records to discover the realities of the transaction. The importance of this analysis cannot be overemphasized. In essence, all (or virtually all) IRC 482 cases can be reduced to the following questions:

1. What was done?
2. What economically significant functions were involved in doing it?
3. Who performed each function?
4. What is the measure of the economic value of each function performed by each party?
5. How does the transaction fit within the total economic arrangements between the related parties?

In most cases this information will be obtained from actually questioning appropriate personnel of the various organizations.

If, while considering IRC 482, it is determined that "substantial services" are being

rendered by one related entity for another, subpart F section 954(e), concerning foreign base company services income, should be considered.

Section 482 and the foreign base company services provisions are not mutually exclusive. Both may well come into play in a single case. Section 482 would determine whether the U.S. related entity should be compensated for services or intangibles utilized in earning the income that the taxpayer is attributing to the CFC. After any necessary §482 adjustments are made, the foreign base company services provisions are applied to determine if any part of the CFC's remaining income is Subpart F income which is taxable currently to the U.S. shareholders.

IRC 954(e) defines foreign base company services income as income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which (a) are performed for, or on behalf of, a related person and (b) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

Section 1.954-4(b)(1)(iv) defines services which are performed for or on behalf of a related person to include (but not limited to) services performed by a controlled foreign corporation in a case where substantial assistance contributing to the performance of such services has been furnished by a related person or persons.

Under section 1.954-4(b)(2)(ii)(a), substantial assistance applies where assistance is furnished by a related person or persons to a controlled foreign corporation in the form of (but not limited to) direction, supervision, services, know-how, financial assistance (other than contributions to capital), equipment, material, or supplies.

The regulations further provide that assistance furnished in the form of direction, supervision, services, or know-how will not be considered substantial unless the assistance so furnished provides the controlled foreign corporation with skills which are a principal element in producing the income, or the cost to the CFC of the assistance so furnished equals fifty percent or more of the total cost to the CFC of performing the services performed by such corporation. (Section 1.954-4(b)(2)(ii)(b) of the regulations).

In considering the applicability of the foreign base company services provisions, it is not relevant whether the controlled foreign corporation paid for the substantial assistance received from a related entity. For example, a U.S. parent corporation may furnish engineering services to unrelated third parties for an hourly charge of \$200 per hour. Should the parent furnish the engineering for a foreign project to its controlled foreign corporation on the same hourly basis, and those engineering services are considered substantial under Treas. Reg 1.954-4(b)(2), the income from the project would constitute foreign base company services income regardless of the fact that the

controlled foreign corporation paid the parent for the services.

One of the means by which CFCs receive substantial assistance from related entities is through temporary "loans" of skilled employees. These employees remain in their permanent employer's pension and profit sharing plans and are usually guaranteed the right to return to the permanent employers after the tour of duty with the controlled foreign corporation.

The determination of foreign base company services income is made on an item of gross income by item of gross income basis. Thus, the examiner must find substantial assistance with respect to a particular project or contract. A general finding that related entities rendered substantial assistance to a CFC is inadequate since the substantial assistance may have related entirely to one particular project while other projects were performed by the CFC unassisted.

COMMENTS

As stated previously, IRC 482 issues can arise in a wide variety of circumstances, and each one must be decided on its own facts and circumstances. For this reason, development of specific guidelines for IRC 482 issues is difficult. (See IRM 4232.7-85 Audit Techniques - International Enforcement - Chapter 500 of Tax Audit Guidelines).

In relation to IRC 482 services, we might want to take the following approaches:

1. Make the functional analysis as referred to previously. (It, of course, is recognized that this is no simple task).
2. Obtain the services of an economist to help with the functional analysis.
3. If the domestic taxpayer has made charges to the controlled foreign corporation for services (management, engineering, etc.), review these as to how the charges were arrived at, and if they are arm's length in nature.
4. Based partially on information obtained in the functional analysis, an allocation of income from the CFC to the U.S. parent may be in order. After the functional analysis has been made, the information may indicate that the primary issue should be subpart F services income, rather than IRC 482, or vice versa.